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Bankruptcy Trends: Paradigm Shift or Simple Evolution?

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There have been two primary shifts related to bankruptcy law that affected the practice in 2006. The first of these actually began in late 2005, involving amendments to the Bankruptcy Code itself, which consequently made bankruptcy law more creditor friendly. In particular, Section 503(b)(9) was added, which now provides that all goods purchased by a debtor within twenty days prior to the filing of bankruptcy are accorded administrative priority claim status, meaning that any debtor who has purchased goods and services within twenty days prior to a bankruptcy filing must pay those creditors in full in order to successfully emerge from bankruptcy. In addition, reclamation rights (the rights of a creditor who has sold goods to a debtor prior to bankruptcy to recover those goods still on hand with the debtor) have been extended to include goods delivered up to forty-five days prior to the bankruptcy proceeding. Although banks with senior liens may often defeat creditors' reclamation rights, the new Section 503(b)(9) allows creditors to at least obtain an automatic administrative claim for goods sold within the twenty-day requirement. Both of these changes to bankruptcy law will make it more difficult for debtors to emerge from bankruptcy, consequently pushing debtors to seek alternative ways to restructure their debt.

Another significant shift has been the increasing efficiency of the capital markets within the United States through the rapid proliferation of private equity funds, to the point where there is now a tremendous amount of available liquidity for troubled companies. Bankruptcy and restructuring professionals across the country are finding that numerous deals are being funded that several years ago would have otherwise ended up in bankruptcy. Until interest rates rise significantly, and the capital markets materially tighten, no one will know for sure whether we are witnessing a permanent shift away from bankruptcy or simply an anomaly.

Although the number of business bankruptcies across the country has dropped dramatically, I do not believe a permanent shift from bankruptcy has occurred. Rather, in my view, the situation today is analogous to the stock market in mid-2000, when people claimed there was a paradigm shift and that the cycle of boom and bust had been flattened to a constant rate of growth. Of course, that was disproved shortly thereafter. Likewise, in the bankruptcy arena, some people are fearful that the bankruptcy practice has

simply dried up. In contrast, I see the current situation as simply a byproduct of historic levels of available liquidity and relatively low interest rates, which has allowed many marginal companies to survive.

The Evolution of Legal Strategy in Bankruptcy Practice

As bankruptcy lawyers, we cannot count on Congress to push back the changes that have been made to the code, no matter how much some practitioners may wish it would. Therefore, the restructuring practice will almost certainly continue to shift toward non-judicial restructurings whenever possible. As a result, it will be more important than ever for a company to analyze whether it can be restructured consensually with its traditional bank-secured creditors (or private equity funding) in a way that does not require a bankruptcy proceeding.

Although I am still involved in several asbestos-related bankruptcies, there seems to be a significant slow down in the number of companies filing because of asbestos exposure. To my knowledge, no significant companies have filed in the last six to twelve months. There is some question as to whether the asbestos problem has leveled off to the point that, while it will remain chronic, it will no longer be acute.

Furthermore, there is a growing trend toward closer examination of the internal organizations within multi-corporate family companies. Conglomerates are becoming more sensitized to the need for inter-company firewalls so that the liability of your subsidiary does not pierce through to all the various companies within the corporate family. Consequently, we may see corporations become even more formalized in terms of their inter-company transactions.

As a result of all these changes, our strategy for working with clients has evolved. When working on the creditor side, we are increasingly focused on looking for a non-bankruptcy solution to the problem, whether through restructuring or litigation. There have been several matters this year in which a client was presented with a significant account receivable that was delinquent, and as a result of which we would expect the debtor to file bankruptcy upon obtaining judgment. However, that is no longer

necessarily the case, and many times we have found ourselves in a situation where the debtor is more willing to negotiate and fund a settlement, rather than file for bankruptcy. The ability to effectively negotiate in these situations is therefore increasingly important.

Negotiation and Settlement Strategy: Understanding Your Leverage

In negotiations today, there is an even greater willingness to be highly aggressive in representing a creditor, given that the option of bankruptcy is no longer as viable for a debtor as it was previously. From a strategy standpoint, it is obviously important to look at the debt structure of the company, as companies are becoming more and more leveraged in terms of primary, secondary, and tertiary levels of debt. Some of the secured creditors may not want a judgment obtained and execution proceedings commenced, thus opening the possibility that the secured creditor will lend money to avoid the judgment without forcing the company into bankruptcy.

Moving forward, I believe that settlements and negotiations in bankruptcy law will grow even more complicated. Many traditional banks are no longer holding onto their debt positions as they once would have. For example, if a particular national bank has a credit line that has gone into default for a debtor company, their workout group would traditionally have handled the ultimate resolution. However, many banks are now simply selling off bad debt. Some buy the debt simply to arbitrage it, hoping that if they buy it at a discount, they will ultimately be paid in full and their profit will equal the difference. Others buy debt to attempt to wrest control of the debtor company. Therefore, it is critical to understand who is holding the debt and what their motivations are before determining your strategy on a client's behalf.

If I am working on behalf of a fund, I may well be looking to convert the debt to equity and, in doing so, simply take over ownership of the company. If I represent an unsecured creditor, my negotiation strategy will depend upon whether I wish to continue the relationship with the customer rather than being paid in full. In the case of an unsecured creditor, as mentioned above, the leverage changes somewhat in the context of bankruptcy, given that all debt incurred within twenty days of the

bankruptcy filing is subject to administrative claim status under the new laws. Therefore, it is no longer necessary for an unsecured creditor to make as many concessions to a debtor to enhance its position.

There has also been a leverage shift in favor of landlords in real estate situations. The period of time in which a debtor must decide whether to assume or reject an executory contract has been shortened and can no longer exceed 270 days after the filing of a petition without landlord consent. Consequently, landlords are able to force a decision from a delinquent tenant in less than a year. If I am representing a landlord, I know that a retail debtor will typically want to make it through the Christmas selling season and thus is more likely to make concessions to keep the lease in place. Likewise, the landlord has more confidence in knowing a statutory deadline exists by which it will either get its leased premises back or the debtor will assume the lease.

Unusual Cases

Several months ago, I pursued a collection action in which we moved for the appointment of a state court receiver, which was not a typical approach. Usually, collection actions are simply taken to judgment, or the debtor is forced into bankruptcy. However, because we moved for the appointment of a receiver, obviously to the dismay of the debtor, we were able to negotiate a favorable settlement on an expedited basis. We filed a complaint and demanded the immediate appointment of a receiver on the grounds that the business assets were being used by an affiliated entity without benefit to the debtor's estate. The debtor had no desire to have a receiver appointed or a bankruptcy filed because it would impair the principal's ability to sell off assets in an orderly fashion to pay down a secured creditor to which the principal had issued a personal guaranty.

In another example, we represented a creditors' committee in an automobile parts case. The debt was bought by a fund, the purpose of which we believed was the acquisition of the company. The committee engaged in aggressive litigation with the fund, as we felt the fund was wearing multiple hats in both management and debt ownership. In this kind of situation, we have found that litigation focused on multiple relationships

can ultimately lead to a favorable settlement for the creditors. The multiple relationships lead to potential claims for breach of fiduciary duty, usurpation of corporate opportunity, and other claims. Such claims in the right court can gain sufficient traction to result in a favorable outcome; however, they are often hard fought and require tenacity and creativity.

An Objective View of Corporate Structure

We have begun to look at inter-company dealings from more of an arm's length perspective. I do a significant amount of teaching in the energy industry, and a common point of focus is on the internal structure of a multi-corporate family to determine the separateness among affiliated companies. Customers very often make purchases from a conglomerate using a d/b/a, or "Doing Business As," name, which makes it very difficult to keep track of who one is doing business with, within the corporate family. If that particular debt goes bad, it is even more difficult to determine from whom the debt should be collected. Therefore, there has been a great deal of focus recently on the creditors' side on ensuring that the selling company understands who their customer is and, by extension, who will be legally responsible for paying if the debt goes bad. As corporate structures grow more complex, it becomes increasingly critical to understand this point.

The Five Strategic Changes of 2007

First, it is increasingly important to look for alternative, non-bankruptcy methods for resolving collection issues and outstanding debt. Second, we are focusing on the capital structure to determine who is holding the debt of a particular company and what their motivations are, so that we in turn can develop an effective strategy for resolving the debt. Third, we remain highly aware of globalization issues, particularly where a company has foreign subsidiaries that have an impact on its structure. Fourth, we focus on sector anomalies where, while the economy itself may be strong, there may exist a unique problem in one particular sector.

On the point of globalization specifically, we represent a number of companies that are based in the United States, but that are doing business

outside of the United States with other U.S. companies that have foreign subsidiaries. It is important to recognize the legal issues surrounding the fact that these are truly separate companies on both the buyer and seller side. Many of the recent auto cases involved filing a bankruptcy that also affected foreign subsidiaries that were not in bankruptcy. Therefore, although the parent company may be in bankruptcy, it is quite possible that the subsidiary is not. When that is the case, your ability to collect the debt may be greatly enhanced, as the company against whom the claim has been made is not in bankruptcy. Knowing where the company is located, what their assets are, and what laws apply to them is a critical part of the evolving bankruptcy practice.

Strategizing for 2007

From a creditor's perspective, I am seeing an increasing focus on anticipating and avoiding problems before they occur. This means focusing on fixing internal systems and truly understanding the structure and geographic issues involving one's customer. While this has always been an issue in bankruptcy law, I believe it is becoming more and more important to understand each step in the process and how those steps affect each other. Therefore, I see myself becoming more involved from the front end, particularly in connection with the energy credit arena, where we do a great deal of teaching on how to understand the impact of internal credit intake versus the ultimate collection on bad debt. These points tie together in ways that are not necessarily always apparent.

Francis J. Lawall, a partner in the Philadelphia office of Pepper Hamilton LLP, concentrates in national bankruptcy and reorganization matters, including the representation of creditors' committees in bankruptcy proceedings, workouts, and restructurings throughout the United States. Mr. Lawall also has experience in the reorganization of companies plagued with massive toxic tort liabilities, as well as companies in the paper textile, automotive, clothing, and construction materials industries.

Mr. Lawall routinely lectures in the long-term credit education program offered by the International Energy Credit Association, which includes "Credit 101" and related seminars. He has presented seminars to the American Bar Association's Subcommittee

on Mass and Massive Torts concerning the use of limited fund class actions as an alternative to bankruptcy. He also lectures regularly to various creditor groups concerning general bankruptcy issues, including preferences, reclamation, the role of creditors' committees, and related issues.

Mr. Lawall has published on a variety of bankruptcy and credit issues. In addition, he writes monthly articles on current bankruptcy issues for The Philadelphia Legal Intelligencer.

Mr. Lawall received his B.A. in economics from Temple University in 1981, his M.A. in economics from Temple University in 1982, and his J.D. from Temple University School of Law in 1985.



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